

Credit Union Commercial Business Lending: Key Issues for Legislation in the 112th Congress

June 20, 2012

Congressional Research Service

<https://crsreports.congress.gov>

R42574

Summary

Credit unions currently can make loans only to their members, to other credit unions, and to credit union organizations. In addition, there are restrictions in law on their business lending activities from which the credit union industry has long advocated for relief. Specific restrictions on business lending include an aggregate limit on an individual credit union's member business loan balances and on the amount that can be loaned to one member. Industry spokesmen have argued that easing the restrictions on member business lending could increase the available pool of credit for small businesses. Community bankers argue that raising the business lending cap would allow credit unions to expand beyond their congressionally mandated mission and possibly pose a threat to financial stability.

Legislation has been introduced in the House and Senate to raise the business lending cap for credit unions: H.R. 1418 and S. 2231, which are both titled the Small Business Lending Enhancement Act of 2011. Currently, the business lending cap for a credit union is 1.75 times of its actual net worth or 12.25% of the total assets of the credit union, whichever is less. The legislation would increase the cap to 27.5% of the total assets. A subcommittee of the House Financial Services Committee has held one day of hearings on H.R. 1418.

Although "small business lending" appears in the bill title, the legislation does not contain firm size or loan size restrictions. The Small Business Administration (SBA) often uses the Federal Deposit Insurance Corporation's (FDIC) definition of a small-business loan as either a commercial real estate or commercial and industrial (C&I) loan of \$1 million or less. If the bills were enacted as currently written, credit unions would be able to make all C&I loans—those fitting the FDIC's definition and, in addition, those greater than \$1 million. Hence, the legislation would allow credit unions to become larger competitors in the commercial lending market. It would not limit credit unions to making only small-business loans or to targeting their lending to small firms.

Although the legislation would allow credit unions to possibly become important competitors with community banks, the differences in capital regulatory requirements may not necessarily threaten financial market stability or expose the National Credit Union Share Insurance Fund, which is the federal deposit insurance fund for credit unions, to greater default risk. A comparison of capital requirements presented in this report shows that credit unions may hold less capital relative to banks for loans with maturities of five years or less, but they must hold more capital for loans of longer maturities.

Recent evidence pertaining to the demand for small business credit appears to be mixed. Regardless of the current demand for credit, credit unions are likely to be just as cautious as banks when granting commercial loans given the slow pace of the U.S. economic recovery. Tight lending standards are expected to persist until the macroeconomic outlook grows more favorable.

Contents

Background Information	1
Credit Union Member Business Lending	1
Legislation in the 112 th Congress	3
Key Issues.....	3
Definitions of Small-Business Loans and Small Businesses	3
Regulatory Arbitrage Considerations	4
Safety and Soundness (Capital Adequacy) Regulation.....	5
Fair Lending Regulation	6
Demand and Supply of Commercial Loans for Small Businesses	7

Tables

Table A-1. Community Bank Capital Requirements	9
Table A-2. Credit Union Capital Requirements.....	10

Appendixes

Appendix. Comparison of Capital Requirements for Community Banks and Credit Unions	9
---	---

Contacts

Author Information.....	11
-------------------------	----

Background Information

The original concept of a credit union was of a cooperative organization formed for the purpose of promoting thrift among its members and providing them with a source of low-cost credit. During the past couple of decades, technology, competition, and economic conditions have brought many changes to the financial services marketplace, which have affected all types of depository financial institutions. The credit union industry has evolved with marketplace changes so that many of the financial services that credit unions provide are similar to those offered by banks and savings associations.

Credit unions nevertheless remain distinguishable because of their cooperative framework and unique charter requirements. Credit unions are nonprofit, member-owned financial institutions and are subject to specific restrictions not placed on other depository financial institutions. Given that credit unions are considered financial cooperatives, the institutions are exempt from federal income tax. Individual members are taxed on their dividends.

Credit union charters are granted by federal or state governments on the basis of a “common bond.” This requirement determines the “field of membership,” and it is unique among depository financial institutions. There are three types of charters: (1) a single common bond (occupation or association based); (2) multiple common bond (more than one group each having a common bond of occupation or association); and (3) a community-based (geographically defined) common bond.

Individual credit unions are owned by their membership. The members of a credit union elect a board of directors from their institution’s membership (one member, one vote). Members’ savings are referred to as “shares” and earn dividends instead of interest. Credit union loan and investment powers are more restricted than those of commercial banks. Credit unions can only make loans to their members, to other credit unions, and to credit union organizations. The investment authority of federal credit unions is limited by statute to loans, government securities, deposits in other financial institutions, and certain other limited investments.

The National Credit Union Administration (NCUA), an independent federal agency, is the federal regulator for credit unions. The National Credit Union Share Insurance Fund (NCUSIF) is the federal deposit insurance fund for credit unions. The NCUA manages the NCUSIF for the credit union industry.¹ As of December 31, 2011, there were 7,094 federally insured credit unions; these federally insured institutions held assets totaling \$961.8 billion.²

Credit Union Member Business Lending

There was no commercial lending cap on the amount of member business loans that credit unions could make until 1998. In response to a Supreme Court decision, Congress passed the Credit Union Membership Access Act of 1998 (CUMAA; P.L. 105-219), which among other provisions, established a commercial lending cap.³ First, the CUMAA codified the definition of a credit union

¹ See CRS Report R41718, *Federal Deposit Insurance for Banks and Credit Unions*, by Darryl E. Getter and Victor Tineo.

² See NCUA fourth quarter announcement at <http://www.ncua.gov/News/Pages/NW20120301Q4IndustryCReport.aspx>.

³ For a discussion of the Supreme Court decision and congressional response to it that resulted in P.L. 105-219, see William R. Emmons and Frank A. Schmid, *Credit Unions and the Common Bond*, Federal Reserve Bank of St. Louis, Review, September/October 1999, at <http://research.stlouisfed.org/publications/review/99/09/9909we.pdf>.

member business loan (MBL). An MBL is any loan, line of credit, or letter of credit used for an agricultural purpose or for a commercial, corporate, or other business investment property or venture. Second, the aggregate amount of outstanding business loans to one member or group of associated members was limited to a maximum of 15% of the credit union's net worth or \$100,000, whichever is greater. Third, CUMAA limited the aggregate amount of MBLs made by a credit union to the lesser of 1.75 times the credit union's net worth or 12.25% of the credit union's total assets. Finally, three exceptions to the credit union aggregate MBL limit were authorized for (1) credit unions that have low-income designation or participate in the Community Development Financial Institutions program;⁴ (2) credit unions chartered for the purpose of making business loans (as determined by the NCUA); and (3) credit unions with a history of primarily making such loans (as determined by the NCUA).

At the time of CUMAA, some Members of Congress were still concerned that commercial lending, which is considered riskier than consumer lending, would increase the risk profile of the credit union system. In deliberations over the CUMAA, Members expressed concern that a 12.25% cap was too high if small loans (under \$50,000) were not counted toward the cap, and were also concerned that such an exemption could open up a regulatory arbitrage opportunity enabling chartered credit unions to assume more financial risk and circumvent the cap limitation in the legislation.⁵ Hence, the 12.25% lending cap arguably represented a compromise.

The volume of credit union member business lending has increased over time, but MBLs continue to account for a small share of total credit union lending. The number of credit unions reporting an increase in member business lending increased from 5% of all credit unions in 1986 to 30% in 2010.⁶ According to the NCUA, approximately 30% of credit unions that were subject to the commercial lending cap provided MBLs as of June 30, 2011.⁷ The credit unions collectively provided a total of \$28.47 billion of MBLs, which equaled 3.2% of total credit union assets of \$881.33 billion as of June 30, 2011.⁸ The NCUA also reported that the median of the average MBL size is \$126,316, compared with the average size of bank C&I loans, which was approximately \$675,000.⁹ The NCUA reported that 82% of MBLs were secured by real estate, with some credit unions heavily concentrated in agricultural loans. The majority (84%) of credit union failures over the 2009 and 2010 periods were unrelated to MBL defaults.

⁴ A designated Community Development Financial Institution works in financial market niches that are underserved by traditional financial institutions. For more information, see the CDFI website at http://www.cdfifund.gov/what_we_do/programs_id.asp?programid=9.

⁵ For example, see additional views in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Credit Union Membership Access Act*, To accompany H.R. 1151, 105th Cong., 2nd sess., May 21, 1998, S.Rept. 105-193.

⁶ See James A. Wilcox, *The Increasing Importance of Credit Unions in Small Business Lending*, Office of Advocacy, U.S. Small Business Administration, under contract no. SBAHQ-10-R-0009, September 2011, at <http://www.sba.gov/sites/default/files/files/rs387tot.pdf>.

⁷ See the testimony of the Honorable Debbie Matz, Chair of the NCUA, in U.S. Congress, House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, *H.R. 1418: The Small Business Lending Enhancement Act of 2011*, 112th Cong., 1st sess., October 12, 2011, at <http://financialservices.house.gov/UploadedFiles/101211matz.pdf>.

⁸ *Ibid.*, see Figure 2.

⁹ *Ibid.*, page 6 footnotes.

Legislation in the 112th Congress

Legislation has been introduced in the 112th Congress to allow credit unions to expand their member business lending activities. H.R. 1418, the Small Business Lending Enhancement Act of 2011, was introduced by Representative Edward Royce and referred to the House Committee on Financial Services on April 7, 2011.¹⁰ The Subcommittee on Financial Institutions and Consumer Credit held a hearing on the bill on October 12, 2011.¹¹ S. 2231 was introduced by Senator Mark Udall on March 22, 2012, and placed on the Senate Calendar on March 26, 2012.¹²

H.R. 1418 and S. 2231 would amend the Federal Credit Union Act (particularly 12 U.S.C. 1757) to increase the current business lending cap to 27.5% of the total assets of the credit union from the current 1.75 times of the actual net worth or 12.25% of the total assets, whichever is less. The bills would also require credit unions that make business member loans to be *well-capitalized*, which means a credit union's net worth must be equal to or greater than 7% of total (risk-weighted) assets.¹³ In addition, a credit union would need to demonstrate a minimum of five years' experience of sound underwriting and servicing of member business loans.

Key Issues

This next section presents some policy issues related to legislation in the 112th Congress. The legislation would increase the lending authority of credit unions, but it does not require MBLs to meet the definitions of a small business-loan or of a small business. An informal analysis presented in this report asks whether the differences in regulatory requirements for credit unions relative to community banks could translate into greater risks to the stability of the financial system after passage of the legislation. Finally, recent studies pertaining to the current supply relative to demand for small business credit are reviewed to assess whether credit shortages exist.

Definitions of Small-Business Loans and Small Businesses

Although "small business lending" appears in the bills' titles, the legislation does not contain any firm or loan size restrictions. The Small Business Administration (SBA) often uses the Federal Deposit Insurance Corporation's (FDIC) definition of a small business loan as either a commercial real estate (CRE) or commercial and industrial (C&I) loan of \$1 million or less.¹⁴ The SBA also defines a small business on an industry-by-industry basis, with most manufacturing and mining firms deemed small if they have fewer than 500 employees.¹⁵ The Federal Reserve

¹⁰ Related bills were introduced in past Congresses. See CRS Report R40793, *Credit Union Member Business Loans*, by Pauline Smale. For a comparison of H.R. 1418 to an earlier bill, see the Credit Union National Association's website at http://www.cuna.org/download/MBL_HR1418vsHR3380.pdf.

¹¹ See U.S. Congress, House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, *H.R. 1418: The Small Business Lending Enhancement Act of 2011*, 112th Cong., 1st sess., October 12, 2011.

¹² A related bill, S. 509, was introduced earlier by Senator Udall on March 8, 2011, and referred to the Senate Committee on Banking, Housing, and Urban Affairs, which has taken no action.

¹³ The concept of risk-weighted assets is discussed in more detail later in this report.

¹⁴ See definition provided by the SBA's Office of Advocacy at <http://www.sba.gov/sites/default/files/files/rs376.pdf>. The FDIC's definition of small-business loans may be found at <http://www2.fdic.gov/SDI/main.asp>.

¹⁵ Many federal agencies, including the SBA and the Bureau of the Census, use the 500-employee threshold for defining a business as small for research purposes. See definition of "small business" provided by the SBA's Office of Advocacy at <http://web.sba.gov/faqs/faqIndexAll.cfm?areaid=24>. For further information and analysis concerning small business size standards, see CRS Report R40860, *Small Business Size Standards: A Historical Analysis of*

defines a small firm as one having total annual sales of less than \$50 million.¹⁶ If the legislation is enacted as currently written, credit unions would be able to make loans (to their members) that meet these definitions. They could also make loans that exceed \$1 million to any size firm as long as their loan portfolios are in compliance with the statutory lending cap.¹⁷

Hence, enactment of this legislation would allow credit unions to increase their presence in the commercial lending market. The NCUA reports that approximately 30% of credit unions subject to the statutory commercial lending cap currently make MBLs. The remaining credit unions may not currently engage in commercial lending because the existing statutory cap may have reduced the cost effectiveness of investing in the necessary underwriting systems.¹⁸ Increasing the lending cap, however, could incentivize more credit unions to incur the implementation costs that might be offset by the revenues generated from a potentially larger volume of MBL originations. Credit unions, therefore, could possibly become important competitors with community banks in the commercial lending market.

Regulatory Arbitrage Considerations

In light of passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act, P.L. 111-203) to “promote financial stability,” it may be useful to consider whether increasing the lending cap would create a regulatory arbitrage opportunity for credit unions. Regulatory arbitrage in this instance refers to the ability to conduct more commercial lending while meeting fewer regulatory requirements relative to banks, which could then translate into a competitive advantage and possibly introduce new risks to the financial system. Given that credit unions face different safety and soundness (capital adequacy) as well as fair lending requirements than those applicable to community banks, these issues are defined and discussed in more detail in this section.

Community banks, which are commonly defined as financial institutions that hold assets below \$1 billion, share some similarities to credit unions with respect to their business structures.¹⁹ For example, community banks and credit unions engage in “relationship banking,” which involves developing close familiarity with their respective customer bases. Community banks typically provide financial services within a circumscribed geographical area. The development of close relationships helps community banks understand idiosyncratic lending risks in their local areas that may not be easily understood using a computerized underwriting methodology.²⁰ Similarly,

Contemporary Issues, by Robert Jay Dilger.

¹⁶ See definition of “small firm” provided by the Federal Reserve at <http://www.federalreserve.gov/boarddocs/snloansurvey/201201/fullreport.pdf>.

¹⁷ See http://www.cuna.org/gov_affairs/state_affairs/download/part_723.pdf.

¹⁸ See the testimony of the Honorable Debbie Matz, Chairman of the NCUA at U.S. Congress, House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, *H.R. 1418: The Small Business Lending Enhancement Act of 2011*, 112th Cong., 1st sess., October 12, 2011, pages 11-12, at <http://financialservices.house.gov/UploadedFiles/101211matz.pdf>.

¹⁹ An alternate and more extensive definition of a community bank is associated with its functions as opposed to its asset size, which is discussed in an FDIC presentation at http://www.fdic.gov/news/conferences/communitybanking/community_banking_by_the_numbers_clean.pdf.

²⁰ Large financial institutions perform “transactional banking” or high-volume lending that relies heavily upon automated underwriting. For more information on automated underwriting, see Wayne Passmore and Roger Sparks, *The Effect of Automated Underwriting on the Profitability of Mortgage Securitization*, Federal Reserve Board, Finance and Discussion Series 1997-19, Washington, DC, 1997, at <http://www.federalreserve.gov/pubs/feds/1997/199719/199719abs.html>.

credit unions provide financial services to their restricted memberships. The development of close relationships helps credit unions tailor product offerings to their unique memberships. Both credit unions and community banks also rely primarily upon deposits to fund their assets (loans). In other words, community banks and credit unions borrow primarily from their depositors to obtain the funds necessary to provide customer loans rather than from the short-term financial markets that the larger banking institutions access more frequently.

The business models for these institutions, however, differ given that community banks are not cooperatives. Community banks are for-profit financial institutions,²¹ and they may accept deposits and provide lending services without any restrictions on their customer base. Consequently, aside from safety and soundness requirements, there are no additional statutory limitations on the amount of CRE and C&I loans that community banks may originate.²² The safety and soundness regulation, as well as fair lending requirements (discussed below), differ for credit unions and community banks.

Safety and Soundness (Capital Adequacy) Regulation

An essential component of safety and soundness regulation for all financial institutions is concerned with the capital reserves they must maintain to absorb losses associated with loan defaults. If financial institutions have sufficient capital buffers to absorb losses from nonperforming loans, then insolvencies and subsequent failures, which impose economic costs and could threaten financial market stability, are less likely to occur.²³ Capital, for the purposes of safety and soundness regulation, is defined as the difference between the assets (or loans) of a financial institution and its liabilities. A capital-asset ratio is computed by placing a financial institution's total capital in the numerator of the ratio and then dividing by its total assets, which are usually weighted by default risk.²⁴ This computation is referred to as a capital-asset ratio for a bank and a net worth-asset ratio for a credit union.

Community banks are required to maintain a *total risk-based capital-to-asset ratio* in the amount of 8% to be classified as *adequately capitalized*, and a ratio of 10% or greater to be classified as *well-capitalized*.²⁵ A large percentage of bank capital is held in the form of equity shares. Credit unions do not issue equity shares and, instead, must maintain a certain ratio of net worth (assets

²¹ Credit unions are exempt from federal income taxes given that they are considered to be non-profit cooperatives. See CRS Report 97-548, *Should Credit Unions Be Taxed?*, by James M. Bickley. Some community banks, however, do not pay taxes at the corporate tax rate if they elect to become a subchapter S corporation "pass-through" entity for tax purposes. Rather than pay corporate income taxes, a subchapter S corporation may pass the income tax liability to its shareholders who pay taxes according to individual tax rates. See CRS Report R42451, *Taxing Large Pass-Throughs As Corporations: How Many Firms Would Be Affected?*, by Mark P. Keightley. To compute the number of community banks that are subchapter S corporation banks (by state), see <http://www.fdic.gov/bank/analytical/stateprofile/>.

²² Bank regulators, however, are concerned about the risk management practices of smaller, regional banking institutions when their balance sheets show rapid increases in CRE loan concentrations. See Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; and the Federal Deposit Insurance Corporation, "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices," 71 *Federal Register* 74580-74588, December 12, 2006 at <http://www.occ.treas.gov/news-issuances/federal-register/71fr74580.pdf>.

²³ See CRS Report R40417, *Macprudential Oversight: Monitoring Systemic Risk in the Financial System*, by Darryl E. Getter.

²⁴ Risk weights generally rise with the default risk of an asset.

²⁵ See table entitled "Risk-Based Capital Groups" on the FDIC website at <http://www2.fdic.gov/qbp/2011jun/qbp.pdf>. These safety and soundness capital requirements are based upon the Basel I Capital Accord, which is an international framework that establishes capital reserve requirements for banks. For more information on the Basel Capital Adequacy Framework, see CRS Report R42372, *U.S. Implementation of Basel II.5, Basel III, and Harmonization with the Dodd-Frank Act*, by Darryl E. Getter and Gary Shorter.

minus liabilities) relative to risk-weighted assets. Credit unions are required to maintain a *risk-based net worth-to-asset ratio* in the amount of 6% to 6.99% to be classified as *adequately capitalized*, and a ratio of 7% or greater to be classified as *well-capitalized*.²⁶ Hence, it would appear that credit unions meeting the 7% requirement to be *well-capitalized* could hold less capital than a community bank meeting the 8% requirement to be *adequately capitalized*. Moreover, given that credit union safety and soundness requirements are statutory, changing credit union capital reserve requirements would require congressional action.²⁷ The difference in the capital ratio requirements, however, may not translate into a large regulatory arbitrage opportunity when the differences in the asset risk-weighting methodologies used in the computations are considered.

The **Appendix** presents a comparison of how the capital requirements would be computed for three institutions: a bank, a credit union, and a credit union designated as “complex” because it has a high-risk balance sheet and total assets that exceed \$10 million.²⁸ All three institutions are assumed to hold identical assets. The calculations in the example show that complex and smaller credit unions would be required to hold more capital when longer-term loans are originated. Credit unions may hold less capital relative to banks for loans with maturities of five years or less. Capital requirements, however, increase rapidly the more real estate and longer-term investment assets credit unions add and hold in portfolio, which reduces their risk of failure and subsequent demands upon the National Credit Union Share Insurance Fund. While the sample calculations do not support a capital arbitrage opportunity for credit unions for longer-term loan originations, the example does not rely upon a sample of actual balance sheet data from credit unions and community banks. The example also does not account for tax differences or compliance costs associated with fair lending regulation, which is discussed in the next section.

Fair Lending Regulation

Congress enacted the Community Reinvestment Act of 1977 (CRA; P.L. 95-128) in reaction to perceptions that banks were not providing sufficient housing financing to inner cities, preferring instead to make larger, more profitable loans outside of their local communities.²⁹ The CRA has subsequently evolved to also include rural and disaster areas; and it has evolved beyond housing markets to consumer and business lending, community investments, and low-cost services. CRA requires that a federal banking regulatory agency evaluate how each of its regulated institutions meets the credit needs of its entire community, which includes low- and moderate-income (LMI) neighborhoods. No statutorily set rules are imposed; banking institutions, however, typically receive CRA credits after providing LMI loans (subject to existing federal prudential regulations for safety and soundness) or other financial retail services in their communities. Given that larger institutions tend to operate in larger communities that may be more diverse, larger banks usually

²⁶ See Illustration 17-A—Statutory Net Worth Category Classification on the NCUA website at <http://www.ncua.gov/Legal/GuidesEtc/ExaminerGuide/chapter17.pdf>.

²⁷ See James A. Wilcox, *Reforming Credit Union Capital Requirements*, Haas School of Business, University of California, Berkeley, March 3, 2011, <http://www.haas.berkeley.edu/groups/finance/Credit%20Union%20Capital%20Reform%20Wilcox%2020110303.pdf>.

²⁸ CUMAA required NCUA to develop the definition of a “complex” credit union. Hence, a complex credit union, according to 12 C.F.R. 702.103, is defined as having total assets that exceed \$10 million and its risk-based net worth calculation exceed 6%. See <http://www.ncua.gov/Legal/Documents/NCUARegulationsManual.pdf>; <http://www.ncua.gov/Legal/Regulation%20History/702P-65fr8597.pdf>; and <http://www.ncua.gov/Legal/Regulation%20History/702F-65fr44966.pdf>.

²⁹ See CRS Report RL34049, *The Community Reinvestment Act: Regulatory Developments and Issues*, by Darryl E. Getter.

receive more CRA scrutiny than do smaller ones. Nevertheless, all banks must comply with CRA.³⁰ CRA credits become important for a bank seeking permission from its regulator to move offices or to buy another financial institution.

Credit unions are not covered by the CRA. Given that banks may accept deposits from all individuals in a community, CRA provides them with a reciprocal obligation to meet credit needs, as much as possible, of their communities at large. By contrast, credit unions may only accept deposits from individuals that satisfy the membership requirements and they are, therefore, obligated to serve only their memberships. CRA credits would also be of little value to credit unions given that they are not allowed to expand operations beyond their membership groups.

The evidence presented appears to be inconclusive about regulatory arbitrage opportunities. Raising the credit union lending cap would likely translate into more competition for community banks in the commercial lending market, but the differences in capital requirements, tax treatment, and fair lending compliance costs may not necessarily translate into a competitive advantage for credit unions. Although banks have the added costs associated with CRA compliance (and some pay taxes at the corporate rate), credit unions must hold more capital for longer-term loan originations. Both institutions, therefore, face different and possibly offsetting cost factors.³¹

Demand and Supply of Commercial Loans for Small Businesses

The availability of small business credit, in particular for small startups and relatively young firms, is necessary to finance business operations until the revenues from sales are received. Firms, however, tend to produce only what they expect to sell, meaning that they are more likely to reduce production during periods of economic distress when sales are low.³² According to the National Association of Small Businesses, only 3% of small business owners that were recently surveyed ranked credit access as their top problem.³³ Weak sales may arguably be the significant challenge faced by small firms.³⁴ Hence, the macroeconomic impact of raising the credit union lending cap would depend largely upon the willingness of firms to assume new loan obligations during a period of weak sales.

The Federal Reserve, on the other hand, reports evidence that supports a rise in the demand for small business credit. The Federal Reserve attempts to capture the demand for commercial loans by surveying large and small domestic banks every quarter. As of January 2012, domestic banks

³⁰ The overwhelming majority of institutions receive satisfactory or better ratings. According to the Federal Reserve, about 12% of all banks and thrifts that it examined held an Outstanding rating, 87% held a Satisfactory rating, and fewer than 0.5% held a Needs to Improve or Substantial Noncompliance rating as reported on May 21, 2007. See Sandra Braunstein, Director, Division of Consumer and Community Affairs, before the Subcommittee on Domestic Policy, Committee on Oversight and Government Reform, *Bank mergers, Community Reinvestment ACT enforcement, subprime mortgage lending and foreclosure*, at the Carl B. Stokes U.S. Court House, Cleveland, Ohio, at <http://www.federalreserve.gov/BoardDocs/Testimony/2007/20070521/default.htm>, p. 2, May 21, 2007.

³¹ CRS was unable to obtain authoritative data on CRA compliance costs in the course of preparing this report.

³² L. Randall Wray, *The Continuing Legacy of John Maynard Keynes*, The Levy Economics Institute of Bard College, Working Paper No. 514, Annandale-on-Hudson, NY, September 2007, at http://www.levyinstitute.org/pubs/wp_514.pdf.

³³ See remarks by Thomas J. Curry, Comptroller of the Currency, before the Small Business Lending Summit, Washington, DC, April 17, 2012, at <http://www.occ.gov/news-issuances/speeches/2012/pub-speech-2012-62.pdf>.

³⁴ See remarks by Governor Elizabeth A. Duke, Federal Reserve Board of Governors, before the 2011 International Factoring Association Conference, Washington, DC, April 14, 2011, at <http://www.federalreserve.gov/newsevents/speech/duke20110414a.htm>.

reported on net an increase in the demand for C&I loans from all size firms; and the net fraction of banks reporting increased C&I loan demand from small firms increased to its highest level since 2005.³⁵ In addition, the surveyed banks generally reported little change in their lending standards, and they cited a less favorable or more uncertain economic outlook for tightened lending standards. Given that commercial banks have tightened lending standards, credit unions arguably would be just as cautious about extending credit until the pace of the U.S. economic recovery increases, especially considering that their net worth reserve requirements increase exponentially for C&I loans, CRE loans, and loans with maturities that exceed five years.

The willingness to supply commercial business loans may arguably increase given that the willingness to supply mortgage loans may arguably be declining.³⁶ Small community banks may seek new lending opportunities outside of mortgage lending given that recent regulatory requirements have increased the costs of servicing loans.³⁷ The banking industry may experience a dampening in the growth of mortgage servicing in light of the expected limitations on the amount of servicing rights that may count towards bank capital reserve requirements.³⁸ The pool of qualified mortgage borrowers could possibly shrink following final passage of new mortgage lending requirements stemming from the Dodd-Frank Act.³⁹ In addition, the low interest rate environment may be encouraging credit unions to alter their portfolio holdings and realign their investment strategies.⁴⁰ Hence, if the MBL cap is increased, the competition between depository institutions to supply commercial loans is likely to intensify if both groups actively pursue more lending opportunities in this market.⁴¹

³⁵ See <http://www.federalreserve.gov/boarddocs/snloansurvey/201201/fullreport.pdf>; and CRS Report R40985, *Small Business: Access to Capital and Job Creation*, by Robert Jay Dilger, which illustrates the loan demand by small firms as obtained in the Federal Reserve Board's Senior Loan Officer Opinion Survey on Bank Lending Practices. The demand for small business-loans (under \$1 million) is not specifically observed in the survey.

³⁶ Harry Terris, "New Mortgage Names Rise as Oligopoly Reconfigures," *American Banker*, February 23, 2012, at http://www.americanbanker.com/issues/177_37/mortgage-origination-market-share-1046909-1.html.

³⁷ See submitted Letter from Independent Community Bankers Association to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, May 2, 2011, at http://www.federalreserve.gov/SECRS/2011/May/20110511/R-1406/R-1406_050211_69605_431796476192_1.pdf.

³⁸ See "FR Y-14: Basel III and Dodd-Frank Schedule Instructions" at http://www.federalreserve.gov/reportforms/formsreview/FRY14A_20120118_f.pdf; and "Ocwen Believes Basel Regulations Give Nonbanks Upper Hand in MSR (Mortgage Servicing Rights) Purchases," at <http://www.housingwire.com/news/basel-regulations-translating-growth-nonbank-funding-mortgage-servicing-rights>.

³⁹ For information on the qualified mortgage rule, see CRS Report R42056, *Ability to Repay, Risk-Retention Standards, and Mortgage Credit Access*, by Darryl E. Getter.

⁴⁰ See Mark Reed, "Investment Portfolio Increases, Components Shift," *CreditUnions.com*, April 16, 2012, at <http://www.creditunions.com/article.aspx?articleid=4989>.

⁴¹ Interest in C&I lending may also be rising for larger banks. See Andy Peters, "Community Bankers Fight Back Against Big Rivals for C&I Loans," *American Banker*, November 22, 2011.

Appendix. Comparison of Capital Requirements for Community Banks and Credit Unions

Although banks and credit unions have different capital reserve requirements, the asset risk weighting methodologies make it difficult to determine whether one of these institutions benefits relative to the other one in the form of a regulatory arbitrage opportunity. Hence, the example below illustrates how the capital requirements would be computed for three institutions: a bank, a credit union, and a credit union designated as “complex” because it has a high-risk balance sheet and total assets that exceed \$10 million. The institutions are all assumed to have identical asset portfolios. Beginning with a community bank, its balance sheet assumes risk weights associated with the Basel I Capital Accord.⁴² Consumer loans would consist of a combination of credit card, automobile, student, and personal installment loans. Using the example in **Table A-1**, the community bank below would be required to hold \$630,000 in capital to be *well-capitalized*.

Table A-1. Community Bank Capital Requirements
(Application of Basel I Risk Weights in Percentages; all numbers in thousands of dollars)

Assets Descriptions	Asset Values	0%	20%	50%	100%	Risk-Weighted Asset Values
Cash	\$800	\$800				\$0
Home Mortgages	\$4,400			\$4,400		\$2,200
Commercial Loans	\$2,000				\$2,000	\$2,000
Debt issuances by Fannie Mae or Freddie Mac	\$1,000		\$1,000			\$200
Consumer Loans (Revolving and Non-Revolving Credit)	\$1,900				\$1,900	\$1,900
TOTAL	\$10,100					\$6,300
Capital Requirement Well-Capitalized at 10%						\$630 (\$6,300*0.10)

Source: CRS assumptions and calculations.

Instead of risk weights from Basel I, credit unions use the Risk Based Net Worth (RBNW) rules.⁴³ Under the RBNW methodology, loans with maturities of five years or less are considered to have lower risk and typically would receive a 6% risk weight. Loans that are for (i) longer terms and (ii) exceed a certain percentage of the portfolio would receive multiple weights. For example,

⁴² For an overview of Basel I capital requirements and the Basel III capital requirements, see CRS Report R42372, *U.S. Implementation of Basel II.5, Basel III, and Harmonization with the Dodd-Frank Act*, by Darryl E. Getter and Gary Shorter. Small bank institutions will see increases in capital requirements given that elements of the proposed Basel III rules would apply to all depository institutions regardless of size. See Huberto M. Ennis and David A. Price, *Basel III and the Continuing Evolution of Bank Capital Regulation*, Federal Reserve Bank of Richmond, Economic Brief, EB11-06, June 2011, http://www.richmondfed.org/publications/research/economic_brief/2011/pdf/eb_11-06.pdf. For information about asset risk weighting for banks, see the U.S. Treasury website at http://www.ots.treas.gov/_files/422020.pdf; and the FDIC website at http://www.fdic.gov/regulations/resources/directors_college/sfcb/capital.pdf. For information on the proposed implementation of the Basel III capital requirements for U.S. banks, see the Federal Reserve's website at <http://www.federalreserve.gov/newsevents/press/bcreg/20120607a.htm>.

⁴³ See National Credit Union Administration Regulations, March 2010, Part 74 702.108, Table 5(b) Alternative Components for Standard Calculation at <http://www.ncua.gov/Legal/Documents/NCUARegulationsManual.pdf>.

MBLs that represent 15% or more of total assets would receive multiple risk weights. A value of 6% would be assigned to the amount totaling 15% of the total balance sheet, and 8% would be assigned to the remaining value; if the total value of MBLs exceeded 25% of total assets, the remaining value would receive a 14% risk weight.⁴⁴ Hence, all loans in **Table A-2** will be treated as newly originated loans given that the RBNW for each loan is determined by the maturity length. The mortgage loans are assumed to be fully repaid in 30 years, the commercial loans are assumed to be repaid in 10 years. A bond issued by Fannie Mae or Freddie Mac is assumed to have a weighted average life of between 3 and 10 years.⁴⁵ Consumer loans would consist of a combination of credit card, automobile, student, and personal installment loans, and they are assumed to be repaid in five years.

Using this example, a complex credit union would be required to hold \$777,700 against its lending portfolio to be *well-capitalized*. Complex credit unions are required to hold the *higher* of the risk-weighted asset value or the minimum 7% requirement to avoid NCUA from taking a Prompt Corrective Action against the institution. A typical credit union not meeting the definition of a complex credit union would be required to hold \$707,000 in capital to be *well-capitalized*.

Table A-2. Credit Union Capital Requirements

(Application of Risk Based Net Worth Weights in Percentages; all numbers in thousands of dollars)

Assets Descriptions	Asset Values	0%	6%	8%	12%	14%	Risk-Weighted Asset Values
Cash	\$800	\$800					\$0
Home Mortgages	\$4,400		\$2525 (\$10,100*0.25)			\$1,875 (\$4,400-\$2,525)	\$414
Commercial Loans	\$2,000		\$1515 (\$10,100*0.15)	\$485 (\$2,000-\$1515)			\$129.7
Debt issuances by Fannie Mae or Freddie Mac	\$1,000				\$1,000		\$120
Consumer Loans (Revolving and Non-Revolving Credit)	\$1,900		\$1,900				\$114
TOTAL	\$10,100						\$777.7
Capital Requirement Well-Capitalized at 7% (Minimum Floor for Complex Credit Union)							\$707 (\$10,100*0.07)

Source: CRS assumptions and calculations.

⁴⁴ See National Credit Union Administration Regulations, March 2010, Part 74 702.108, Table 5(b) Alternative Components for Standard Calculation at <http://www.ncua.gov/Legal/Documents/NCUARegulationsManual.pdf>. NCUA assigns a risk weight of 14% to any MBL that exceeds the current 12.25% cap, but this weight may have no relevance if credit unions are currently not allowed to exceed the cap. See Letter from Fred R. Becker, Jr., President and CEO, National Association of Federal Credit Unions, to Becky Baker, Secretary of the Board, National Credit Union Administration, April 18, 2000, p. 12.

⁴⁵ After discussions with NCUA staff, 12% was determined to be the appropriate asset risk weight for this example.

Author Information

Darryl E. Getter
Specialist in Financial Economics

Acknowledgments

The author acknowledges the contributions made by James M. Bickley, Michael Koempel, Robert Jay Dilger, Ted Murphy, and Pauline Smale.

Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS's institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.